

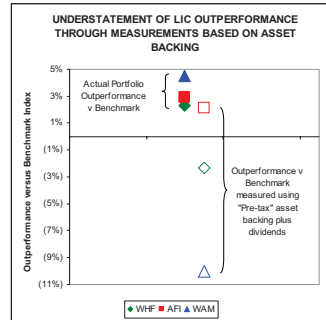
OUTPERFORMING & MISUNDERSTOOD Listed Investment Company Sector

April 2010

Many LICs are generating strong performance.

Inappropriate measures of LIC performance however may mask the quality of the returns achieved.

Listed investment companies can offer investors strong management, above benchmark investment performance and cost-efficient structures. Nevertheless many in the investment community are failing to understand the true strength of investment performance generated by these vehicles.



WHF = Whitefield Ltd, AFI = Australian Foundation Investment Co Ltd, WAM = WAM Capital Ltd
Actual Portfolio Performance measured from returns of the investment portfolio before tax and operating expenses.
Data is 1 year to 31 Mar 2010 for WHF and WAM, and 1 year to 31 Dec 2009 for AFI
Source: Whitefield Ltd, Australian Foundation Investment Co Ltd, WAM Capital Ltd, White Funds Management Pty Ltd estimates

LICs provide After Tax Returns to investors.

A common mistake is to compare a LIC's after tax return against a before tax index.

Listed Investment Companies are After Tax Vehicles

Listed investment companies provide investors with a return that is after the payment of company tax.

Many in the investment community however, are failing to satisfactorily take account of the after-tax nature of these vehicles when assessing performance.

A common mistake is to compare the performance of an LIC's share price and dividends or an LIC's asset backing and dividends (both of which are predominantly after-company-tax measures) against a benchmark such as the ASX200 Accumulation Index which is a measure of before tax performance.

The impact of this error is to understate the relative investment performance being achieved by the LIC for its investors. The quantum of the understatement has the potential to be exceptionally significant. In an average year the investment return achieved by the LIC could be understated by approximately 3% per annum (which equates to the company tax provided by the LIC on the capital gains within its investment portfolio). In years such as 2009/10 where market returns have been over 45%, a LIC's performance could be understated by around 12%.

Understanding the Tax Status of Listed Investment Company Performance

There are several ways to measure the returns generated by a listed investment company for its shareholders. Some of these are before tax measures and some are after tax measures. It is important to understand which measures are before tax and which are after tax.

The following table outlines the differences:

	Before or After Company Tax Measurement
Return of the Market Index (eg S&P/ASX200 Accumulation)	Before Tax
Return of a LIC's Underlying Investment Portfolio	Before Tax
Return of a LIC's share price plus dividends	Partially After Tax
Return of a LICs "Pre-Tax" Asset Backing plus dividends	Partially After Tax
Return of a LIC's "Post-Tax" Asset Backing plus dividends	Fully After Tax

Why "Pre-Tax" and "Post-Tax" Asset Backing and Share Price are Actually After-Tax Measures

Despite the technical title of "Pre-tax" asset backing, the term "Pre-tax" merely refers to the fact that the asset backing is calculated before the provision for tax on unrealised capital gains. Nevertheless "Pre-tax" asset backing of a LIC is still after the payment of company tax on all realised capital gains and unfranked

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Performance measures based on "Pre-tax", and "Post-tax"

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**Asset Backing
or LIC Share
Price are
actually After
Tax Measures**

income. In many instances this may include the payment of company tax on capital gains generated and accumulated over many years or decades.

“Post-tax” asset backing is a reference to asset backing after both the payment of tax on realised capital gains and unfranked income and after the provision for tax on unrealised capital gains. It is clearly an after tax measure.

Movements in the share price of an LIC are predominantly driven by movements in the underlying LIC asset backing (which are after tax measures themselves). Consequently measurements of LIC performance based on share price represent an after tax measure as well.

**Investors in a
LIC obtain a
franking credit
on dividends
paid by the
LIC, providing
them with the
full benefit of
tax paid by
the LIC**

How Investors Obtain the Benefit of Returns Generated by a LIC as an After-Tax Investment Vehicle

Although a LIC pays company tax (at the 30% company tax rate) on unfranked income and realised capital gains, LICs may either distribute the after tax income and gains to an investor as a franked dividend or may retain and reinvest the after tax gain or profit.

If the proceeds are paid to an investor as a franked dividend, the investor will receive the benefit of the franking credit for tax paid at the company level. In addition where the dividend is paid out of LIC discount capital gains, the investor also obtains the benefit of a tax deduction for the amount of the discount applicable to the capital gain. In this way the after tax return to the investor is no different to the after tax return they would receive had they made an identical investment in a managed fund or direct shares.

In the event that the LIC retains, and does not distribute, the after tax income or gain the LIC’s asset backing will rise by the after tax amount of the income or gain. In this situation the tax paid on the retained income or gain is limited to the 30% company tax rate paid by the company. The LIC shareholder however may ultimately have to pay capital gains tax in the normal way on any resulting increase in the share price of the LIC, but only in the event and at the time that they subsequently sell their shares.

**It is generally
misleading to
compare one
LIC against
another LIC
based on
share price or
“pre-tax”
asset backing,
as these
measures fail
to account for
taxation on a
like-for-like
basis.**

The Further Error of Comparing Performance Based on Share Price and Pre-Tax Asset Backing amongst LICs

In addition to the error of comparing after-tax LIC returns against pre-tax benchmarks and indexes, a second common error is to compare the performance of one LIC’s share price plus dividends or pre-tax asset backing plus dividends against those of one or more other LICs.

LICs realise investments and pay company tax on realised gains at different times to one another. As both share price and pre-tax asset backing reflect after company tax outcomes, a comparison of performance amongst LICs based on share price or pre-tax asset backing is neither an accurate reflection of investment performance nor an accurate representation of the benefits of tax deferral.

Some interesting examples of the problems that may arise from comparing LICs based on share price or pre-tax asset backing are highlighted below:

Example 1, Identical Investment Returns, different tax payment times

In the circumstance when two LICs generate identical investment returns from their portfolios, measurements of performance based on share price or pre-tax asset backing would significantly understate the returns of the LIC that sold more investments and paid more tax within the measurement period relative to a LIC that sold fewer investments and paid less tax within the measurement period.

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Example 2, Better Investment Returns, More Tax Paid

In the circumstance where one LIC generates very strong investment returns, but sells some investments and pays tax on those gains, while another LIC generates poorer investment returns, and sells fewer investments and has less tax to pay on gains, comparisons of performance based on share price or pre-tax asset backing would significantly understate the performance of the LIC generating the stronger returns relative to the lower return LIC. It is quite possible performance measurements based on share price and pre-tax asset backing would show the poorly performing LIC as generating better returns than the LIC generating stronger underlying returns.

Example 3, Less Tax Paid Now, More Tax Payable in Future

LICs that have already sold investments and paid tax will have a lower future tax liability than LICs that have sold fewer investments and paid less tax. This creates the perverse situation that investors may be lured into an LIC on the basis of apparently superior share price or pre-tax asset backing performance in the past, yet may find themselves facing higher tax liabilities, and lower share price and pre-tax asset backing performance in future. Similarly investors may avoid investing in LICs that showed lower share price and pre-tax asset backing performance in an earlier year due to the sale of investments and payment of tax, only to find that those LICs have lower future tax liabilities and generate higher share price and pre-tax asset backing performance subsequently.

It is also erroneously argued that measurements of LIC performance based on share price or pre-tax asset backing accurately show the benefits of tax deferred when investments are not sold. This is not correct as the following reasons explain:

- Although an investment may not be sold in one period, tax will ultimately be payable on a gain at some future point in time. As tax will ultimately be payable the benefit of tax deferral is not the amount of tax deferred, it is merely the benefit that may be obtained from use of the money while tax is deferred, until such time as the ultimate tax is paid. This benefit is only a fraction of the actual amount of tax deferred.
- Although a LIC may not sell investments in one period, the underlying LIC investor may sell their shares in the LIC in the period, and as a consequence have to pay tax on any increase in the share price resulting from gains in the LIC's underlying investments. In this event, the LIC investor may not obtain the benefit from tax deferral, and in some circumstances may incur a higher tax liability than if the LIC had sold investments, paid company tax and distributed the proceeds via a fully franked dividend.

Measurements based on share price or pre-tax asset backing also fail to accurately reflect the benefit of tax deferral.

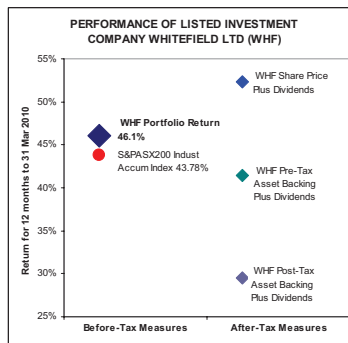
LICs: Outperforming and Misunderstood

The significant difference between the true investment returns being generated by some LICs and some of the commonly quoted, and frequently misunderstood measures of LIC performance can be seen in the examples below.

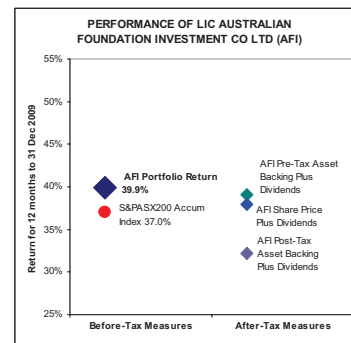
The significant error in measuring LIC performance using share price or pre-tax asset backing can be seen in the following examples of WHF, AFI and WAM.

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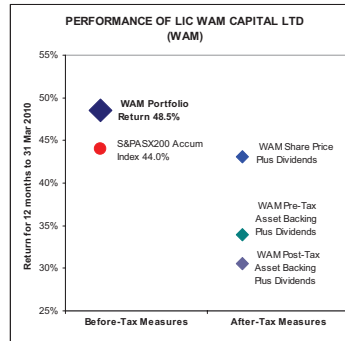


Source: Whitefield Ltd



Source: Australian Foundation Investment Company Ltd, White Funds Management Pty Ltd estimates

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Source: WAM Capital Ltd, White Funds Management Pty Ltd

The Portfolio Return shown in each example is the return of the LIC's underlying investment portfolio calculated on the same basis as the benchmark index (before tax and expenses).

Each of the LICs in the examples above have generated investment returns which outperform their benchmark index over the 12 months to 31st Mar 2010, or in AFI's case to 31st Dec 2009.

In each instance performance measures based on pre-tax asset backing (an after tax measure) understate the actual portfolio return generated by the LIC and are clearly an inaccurate basis for measuring or comparing the returns being generated by these vehicles for their shareholders.

Performance measures based on share price (again an after tax measure) have the potential to be materially misleading in a similar vein.

[It should be acknowledged that in the case of AFI, and for a small number of other LICs, where share realisations and tax payments within a period are very low, performance measured by share price and pre-tax asset backing will be moderately close to underlying portfolio performance. Nevertheless, actual performance achieved for those companies is still understated relative to the before tax benchmark.]

Investors and advisors should make sure that LIC performance comparisons are fair, appropriate and not misleading.

These LICs as well as many other LICs in the Australian market have generated strong investment returns for their shareholders. In many instances these LICs have outperformed their benchmarks over many years or decades. Investors, their advisers and those individuals who research LICs should understand that LICs provide investors with after-tax, not before-tax returns, and should ensure that comparisons of performance are undertaken on an appropriate basis rather than one that may be misleading or inaccurate.

White Funds Management Pty Ltd

White Funds Management is a wholesale investment manager, affiliated with listed investment company Whitefield Ltd. The author holds shares in Whitefield Ltd.

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